

Letter of Findings: 01-20100420
Individual Adjusted Gross Income Tax
For the Year 2008

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ISSUE

I. Adjusted Gross Income Tax – Recognition of Basis.

Authority: IC § 6-3-1-3.5; IC § 6-3-1-11; IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); I.R.C. § 1012; I.R.C. § 1016; I.R.C. § 1366; I.R.C. § 1367.

Taxpayer protests the disallowance of previously-claimed losses due to a recognition of an S corporation basis issue.

STATEMENT OF FACTS

Taxpayer files a joint income tax return with his spouse. Taxpayer is a shareholder of an Indiana subchapter S corporation ("S Corp"). On the 2008 Indiana Schedule K-1, S Corp had an add-back of state wagering tax it had paid and which was deductible *[sic]* for federal purposes. Taxpayer determined that this Indiana adjustment increased the basis in S Corp for Indiana income tax reporting purposes ("Indiana basis"). Without this increased "Indiana basis," Taxpayer would not have been able to apply suspended prior-year losses, because S Corp's 2008 losses allocated to Taxpayer had used up Taxpayer's prior basis. By increasing his 2008 "Indiana basis" by the amount of Indiana tax paid on the income resulting from the add-back of wagering tax, Taxpayer was able to then apply a portion of the suspended losses against the new "Indiana basis."

In reviewing Taxpayer's 2008 income tax return, the Indiana Department of Revenue ("Department") disallowed the previously-claimed losses on the ground that Taxpayer's "Indiana basis" had to be identical to reported federal basis. Taxpayer protested the proposed assessment. The Department conducted an administrative hearing, and this Letter of Findings results. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax – Recognition of Basis.

DISCUSSION

Taxpayer protests the Department's determination that he had no basis in S Corp against which to deduct the prior-year losses.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine individual shareholder's tax liability.

IC § 6-3-1-11 defines "Internal Revenue Code":

(a) The term "Internal Revenue Code" means the Internal Revenue Code of 1986 of the United States as amended and in effect on January 1, 2010.

(b) **Whenever the Internal Revenue Code is mentioned in this article, the particular provisions that are referred to, together with all the other provisions of the Internal Revenue Code in effect on January 1, 2010, that pertain to the provisions specifically mentioned, shall be regarded as incorporated in this article by reference and have the same force and effect as though fully set forth in this article.** To the extent the provisions apply to this article, regulations adopted under Section 7805(a) of the Internal Revenue Code and in effect on January 1, 2010, shall be regarded as rules adopted by the department under this article, unless the department adopts specific rules that supersede the regulation.

(c) An amendment to the Internal Revenue Code made by an act passed by Congress before January 1, 2010, that is effective for any taxable year that began before January 1, 2010, and that affects:

(1) individual adjusted gross income (as defined in Section 62 of the Internal Revenue Code);

(2) corporate taxable income (as defined in Section 63 of the Internal Revenue Code);

(3) trust and estate taxable income (as defined in Section 641(b) of the Internal Revenue Code);

(4) life insurance company taxable income (as defined in Section 801(b) of the Internal Revenue Code);

(5) mutual insurance company taxable income (as defined in Section 821(b) of the Internal Revenue Code); or

(6) taxable income (as defined in Section 832 of the Internal Revenue Code);

is also effective for that same taxable year for purposes of determining adjusted gross income under section 3.5 of this chapter.

I.R.C. § 1366 establishes that an S corporation's shareholders are entitled to deduct the S corporation's

operating loss, passed through to them, up to the amount of their adjusted basis in corporate stock plus the adjusted basis of the corporation's debt. I.R.C. § 1366 (d) sets forth the limitations and, in relevant part, states:

(d) Special rules for losses and deductions.

- (1) Cannot exceed shareholder's basis in stock and debt. The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of
 - (A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and
 - (B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

Therefore, in general, income and/or deductions from an S corporation pass through to the shareholders based on their ownership of the S corporation. However, I.R.C. § 1366(d)(1) provides that losses are limited to the sum of the shareholder's basis in the S corporation stock and the shareholder's basis in "any indebtedness of the S corporation to the shareholder." I.R.C. § 1012 provides that, in general, "[t]he basis of property shall be the cost of such property." Thus, if a person purchases an interest in an S corporation, the purchase price of the interest—rather than the pre-purchase property, income, and expenses of the S corporation—becomes the basis. I.R.C. § 1016(a)(17) and I.R.C. § 1367 provide for adjustments to basis—generally, receipts and expenses of the S corporation.

Under Indiana law as presently written, "Indiana basis" is the federal basis. Neither IC § 6-3-1-3.5 nor any other section of Indiana law permit an adjustment to basis or other adjustments tantamount to adjusting basis in stock to anything other than the federal basis. Compare IC § 6-3-1-1 et. seq. with Model S Corporation Income Tax Act (Multistate Tax Comm'n 1991).

Second, even assuming *arguendo* that Indiana would recognize a different basis than for federal purposes, the provisions that require adding back certain federally-claimed deductions do not create new categories of income. Instead, adding back a federal deduction is Indiana's statutory mechanism to disallow the deduction in determining Indiana adjusted gross income.

While the initial determination of the Indiana basis would not include the deduction in its basis determination, I.R.C. § 1367(a)(2)(D) requires a reduction of basis for nondeductible expenses not properly chargeable to the taxpayer's capital account. The S corporation's wagering taxes are not chargeable to the S corporation's capital account. Thus, even though the wagering taxes are not permitted as a deduction for Indiana purposes, the wagering taxes reduce Taxpayer's basis. Thus, Taxpayer's basis would not change in this instance.

Third, if Taxpayer's argument is accepted at face value, Indiana, pursuant to IC § 6-3-1-3.5(a), determined that certain deductions are disallowable and/or certain income is not taxable. One of the nondeductible items is state income taxes. While the most common adjustments to basis are taxable income and allowable deductions, one purpose of adding receipts and subtracting disbursements from the basis of an S corporation is to prevent excluded income and nondeductible expenses from being included or deducted at a later juncture—for instance, when Taxpayer sells its interest in an S corporation.

To use an example from federal law, a taxpayer owns all the shares of an S corporation. The S corporation has a basis of \$50,000. The S corporation realizes tax-exempt municipal bond income of \$10,000.

If the \$10,000 is not added to basis under I.R.C. §§ 1366(a)(1) and 1367(a)(1) and the taxpayer sells the S corporation for \$60,000 (\$50,000 original basis plus \$10,000 bond income), the taxpayer would have a capital gain of \$10,000 (\$60,000 sales price minus \$50,000 basis). In effect, the \$10,000 in income would be recaptured as a capital gain despite the originally tax-exempt nature of the income. A similar set of adjustments occur for nondeductible expenses.

By requiring the \$10,000 to be added to the taxpayer's basis, the taxpayer realizes no gain or loss upon the sale of the S corporation. Thus, the tax-exempt nature of the income received by the S corporation is preserved.

However, under Taxpayer's approach, \$3,000 in nondeductible income taxes effectively become a deduction by increasing Taxpayer's Indiana basis in the S corporation stock by \$3,000. When the S corporation stock is sold, Taxpayer's gain is reduced by \$3,000 for Indiana purposes. Taxpayer's sought-after increase permits the \$3,000 deduction to be delayed rather than disallowed—contravening Indiana's disallowance provision.

Taxpayer points to language in the 2008 IT-20S instructions for further support of his protest. The instructions under "Basis of Stock in an S Corporation" state:

For Indiana income tax purposes, the basis of a shareholder's stock in an S corporation is generally the same as its basis for federal income tax purposes. Adjustments to income and loss under the Indiana Adjusted Gross Income Tax Act (for the add back of income taxes and the deduction from income for U.S. government obligations) are limited to current reporting but can also affect the shareholder's basis.
(Emphasis added).

Taxpayer's interpretation of the instructions is entirely reasonable. However, the instructions are not supported by Indiana law and do not have the weight of law. Taxpayer's reliance on these instructions for guidance in reporting his Indiana income tax would certainly be relevant in considering waiver of penalties, if any were applied.

Again, under Indiana law as presently written, federal basis is equal to "Indiana basis." IC § 6-3-1-3.5 does not permit an adjustment to basis or other adjustments tantamount to adjusting basis in stock to anything other than the federal basis.

FINDING

Taxpayer's protest is respectfully denied.

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